Hydro Québec Distribution
2010-2011 Rate Application, R-3708-2009
Opening Statement of Robert D. Knecht **11 December 2009**

Good morning Mr. Chairman, members of the panel. I would like to cover the following topics:

- My reasons for recommending an alternative method for the allocation of HQD's "stranded" generating costs;
- My reasons for disagreeing with the recommendations made by Union des Consommateurs witness Mr. Co Pham in respect of stranded generation costs;
- My recommendations for mitigating the growth in cross-subsidies.

HQD Method for Allocation of Stranded Generation Costs

Last year, in Docket No. R-3677-2008, I raised the issue of the allocation of what I called "stranded costs," or what perhaps may be called the costs associated with excess supplies. The costs I was referring to are those incurred by HQD relating to securing generation supplies, but which are *not related to any domestic supply at all*. The stranded costs come in two categories: (a) the fixed costs associated with HQD's contract related to the TransCanada Energy (or "TCE") Bécancour facility, for which zero energy will be supplied in 2010, and (b) the *book* losses on energy purchased by HQD that is resold into export markets. Because these costs are not related to any domestic supply, they are different from both patrimonial supply costs and post-patrimonial supply costs.

As I explained in my evidence (both last year and more briefly this year), I do not agree that the hourly method is the appropriate method for allocating these costs. In fact, these costs are not causally related to any aspect of customer loads, be it time-of-use energy consumption or peak demand. I listed the following reasons:

- It is not possible to assign costs to forecast loads that have not materialized.
- It is not logical to assign contract costs to hours in which no load is supplied.
- In economic terms, the book losses on resold volumes are not real losses. HQD's marginal revenues for those resales exceed the marginal costs of the supply.

- Reductions in industrial load from the forecast levels generally provide a net benefit, not a net cost, to other rate classes.
- The allocation method used by HQD for these costs causes the very unusual and counter-intuitive result that per-kWh post-patrimonial generation costs are higher for high load factor customers than for low load factor customers.

To address this issue, I ask the question: Is the underlying theoretical basis of the hourly method consistent with the allocation of the stranded costs?

The premise of the hourly method is to assign the costs for a particular electricity supply source to the hours *in which the energy is supplied.* While I have a theoretical disagreement that it is appropriate to spread all of the costs for a particular supply contract over all of the hours in which energy is supplied, this is the essential logic of the hourly method. The question is – can stranded costs be reasonably allocated using this principle?

Let me start with the costs associated with the TCE facility. Since this facility provides no energy in the test year, there are no hours in which energy is supplied, and there is therefore no basis within the logic of the hourly method for assigning costs to particular hours. The hourly method therefore cannot apply to these costs. Assigning costs to hours in which the plant might have run is not consistent with the principles of the hourly method. Moreover, arbitrarily assigning the costs to hours in which the supply is not needed is speculative – if the TCE facility were running, there is simply no way to determine the hours in which it would run, and there is no way to determine what the impact of output from TCE would have on generation from other supply sources. In fact, HQD does not really use the hourly method at all, since it assigns costs to hours using a method that is not consistent with the hourly method. I note that HQD's approach includes the assignment of costs to hours in which there is no post-patrimonial supply at all.

The other type of stranded costs is the losses on resale. In this case, we can certainly identify the hours in which the power is resold. And, under the logic of the hourly method, we can identify the average book costs of the power sold in those hours. Unfortunately, the revenues that HQD earns from those resales will not equal those book costs. And under current economic conditions, the revenues are significantly below book costs. Thus, while we can assign the book costs, we cannot assign the book losses. HQD's method pretends that the book

losses in those particular hours are somehow related to the actual consumption in those hours. Unfortunately, this approach is exactly the reverse of the cost causation principle. For losses on resales, if a class increased its consumption in a particular hour, resale losses would decline. However, under HQD's method, an increase in consumption in a particular hour would increase the allocation of costs to that class. In essence, HQD's method sends a cost signal that is exactly backward, discouraging consumption when it should be encouraged, and vice versa.

For those reasons, I conclude that the logic of the hourly method cannot reasonably apply to the stranded costs.

UC Stranded Cost Allocation Proposal

Let me turn briefly to Mr. Pham's thesis on cost causation for stranded costs. As I understand his evidence, he splits the stranded costs into the same two categories as I do. He argues that the costs associated with TCE are caused by the forecast Rate M and Rate L load that did not materialize, and he argues that these costs should therefore be assigned to those rate classes. Regarding resales, if I understand it correctly, Mr. Pham proposes to assign the revenues and costs associated with resales to a separate class of customer. The losses on these resales would then be addressed as a rate design matter, rather than a cost allocation issue.

Regarding Mr. Pham's proposed treatment of the TCE stranded costs, I disagree as a matter of both cost causation and economics. For cost causation, it is simply not possible to assign costs to loads that are lost. HQD will be hard-pressed to recover costs from the forest products mills that have shut down. In most jurisdictions, rather than impose higher costs on struggling industries, regulators will allow rate discounts to be provided in order to retain loads.

More importantly, however, Mr. Co Pham limits his analysis of the implications of the lost load to *post-patrimonial* generation costs. He does not recognize that any lost industrial load provides a very substantial offsetting benefit to remaining customers. Remember that the *patrimonial load* is allocated to each rate class in proportion to overall consumption. If industrial load had been much higher, it would have been assigned its share of the patrimonial load. And, of course, the other classes' share of the patrimonial load would be much lower. Using Mr. Co Pham's table, I estimate that, had the forecast materialized, the Domestic class's share of patrimonial load would be about 3.4 TWh lower. This shortfall would, of course, have had to be

provided by post-patrimonial supplies, and I estimate that the *increase* in costs assigned to the Domestic class would be at least $140 million.

The economic reality that is not reflected in Mr. Pham's proposal is that the lost industrial load does not impose a net cost on HQD or on other generation customers. A typical large industrial customer pays rates of about 4.5 cents per kWh, of which some 2.6 cents per kWh is related to generation supply. A reduction of 1 kWh of industrial load reduces generation revenues to HQD by 2.6 cents per kWh. If that reduction is met by reselling power, HQD sees offsetting revenues equal to the resale price. This year, the resale price reported by HQD is 3.4 cents per kWh, in excess of the foregone generation revenues. Last year, the resale price was 6.3 cents per kWh, well in excess of *total* foregone industrial revenues. In effect, HQD's other customers are better off if HQD resells the power than by selling to domestic industrial customers. Similarly, if that reduction would otherwise have been met by generation at the TCE facility HQD would see a saving equal to the marginal cost of supply from TCE. Since the marginal cost of TCE supplies must be higher than the resale price (or otherwise HQD would resell the power), HQD's remaining customers are again better off without the industrial load than with it.

In short, Mr. Pham's thesis is that remaining industrial customers should pay for stranded *post-patrimonial* costs allegedly caused by lost industrial load. However, if this thesis were adopted, it would also be necessary to assign the *patrimonial* load entitlement for the missing load to the remaining industrial customers. That is, if the remaining industrial load is obligated to pay for costs associated with lost load, it should also get the lost load's share of the patrimonial entitlement. In effect, Mr. Pham's proposal is one-sided. In his approach, the non-industrial rate classes obtain all of the benefit of the reduced industrial load, while the remaining industrial customers bear the entire cost burden.

I therefore conclude that Mr. Pham's proposal for TCE stranded costs is consistent with neither economics nor equity.

IEc Alternative Proposal Stranded Cost Allocation

Because the stranded costs related to lost load are not causally related to any measure of consumption or demand, the allocation of these costs is a matter of fairness and judgement.

Although an economic argument could probably be made that these costs should be assigned on the basis of all electric costs, I think that fairness principles suggest that these costs should be treated as generation-related. However, fairness principles should also recognize that there are offsetting benefits associated with reduced load, in the form of greater entitlement to patrimonial supplies for all remaining customers. For that reason, I propose to simply assign these costs in proportion to all other generation costs. Limiting the allocation to only post-patrimonial generation costs would fail to recognize the benefits of greater patrimonial entitlements.

Finally, as I state in my evidence, I do not believe that confidentiality concerns preclude this option. I believe that the allocation of stranded costs using my proposed methodology can be concealed within HQD's hourly methodology just as well as they are currently concealed using HQD's methodology.

Revenue Allocation Proposal

In HQD's 2006 proceeding (R-3610-2006), the Régie adopted HQD's proposal for calculating changes in cross-subsidies from year to year. This method is generally based on unit costs, measured in cents per kWh. Since that proceeding, using that method, the cross-subsidies provided to the Domestic classes have increased by a cumulative amount about $260 million, and will increase by an additional $125 million in this proceeding.

In my evidence, I offer a modest proposal for slowing the growth in cross-subsidies to the Domestic class, by re-assigning about one-third of the increase in cross-subsidies to the Domestic class that would occur in HQD's proposal. Specifically, I propose that $44 million be added to the Domestic rate class increase, representing about 1 percent of current revenues.

Because this will result in a rate increase of only about 1.2 percent for the Domestic classes, I believe it is consistent with the "gradualism" principle of rate design, while it makes at least some modest progress in slowing the increases in cross-subsidies.

Thank you.